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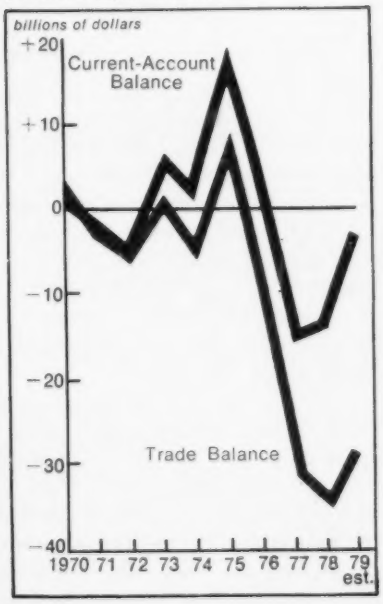
With this issue, International Finance *introduces a unique feature: Eurocurrency market growth data and forecasts compiled by Chase, to appear once each quarter on page 8.*

Behind the U.S. Current-Account Improvement

Members of the Carter Administration and the press have recently expressed optimism about prospects for the U.S. trade and current-account deficits in 1979 and 1980. U.S. manufactured exports are booming as a result of strong foreign growth and the enhanced competitive position of the dollar, while foreign demand for U.S. agricultural commodities is increasing as a result of supply constraints abroad. At the same time, the U.S. slowdown is working to depress non-oil imports.

The combination of these influences would indeed have produced an old-fashioned cyclical swing in the U.S. trade balance were it not for soaring oil imports. The steep oil price hikes are offsetting the export gains and weakened import demand to a large and growing extent. The value of oil imports for the second half of 1979, for example, is projected to rise some 45% above the year-earlier figure, with the promise of further price spiraling and market instability in 1980. All of this points to only a limited narrowing of the trade deficit—to $22-$23 billion in 1979, and to some $20-$25 billion in 1980.

U.S. external accounts
(balance-of-payments basis)



There is, however, some cause for optimism. The invisibles account is moving rapidly in favor of the United States, largely the result of higher earnings from direct U.S. investment abroad. The U.S. current-account deficit will accordingly shrink by roughly $10 billion this year to about $3 billion. And a further improvement of $6-$11 billion expected in 1980 will produce a *surplus* ranging between $3-$8 billion next year, the first surplus in four years.

The improvement in the U.S. current account is hailed by many as the potential curative for the dollar's ailments. However, the improving current account will fail to deliver in this regard, since much of the enhanced invisible-account earnings stem from net unrepatriated receipts from previous direct foreign investment. (These unrepatriated earnings account for about half of the projected improvement in the 1979 current account.) Since these earnings do not return to the United States, there is no commensurate demand for dollars in foreign-exchange markets to buoy the dollar. Thus, foreign-exchange analysts will probably focus on the more limited improvements in the trade balance in the foreseeable future as more accurate indicators of potential dollar strength associated with external-account movements.

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Spanish monetary restraint produces mixed results.

Spanish authorities are expected to maintain a relatively restrictive monetary policy throughout 1979, primarily to combat inflation. So far, the policy has had mixed results. While the year-on-year inflation rate fell to 15.9% for the first half of 1979, compared with 19.7% last year, capacity utilization is below its 1977 level, and investor surveys point to a likely continuation of the trend toward disinvestment. The investment weakness has resulted mainly from the recession in consumer expenditure, but also from the high cost of credit. With the balance of payments continuing in surplus and public-sector borrowing rising, credit to the private sector has been restricted. The resultant fall-off in economic activity has raised the unemployment rate to some 10%. On the positive side, weak domestic demand has fueled the export drive. For the first four months of 1979, exports were up 16.8% above the year-earlier level, while imports were up only 2.5%. Moreover, record capital inflows boosted the end-July reserve level to over $12 billion. The consequent demand for pesetas has continued to strengthen the peseta's exchange value, which rose by 6.4% against the SDR in the January-August period. While this has helped to control the money supply, it is likely to curb export growth for the remainder of the year and especially in 1980, when the added impact of a U.S. and European slowdown takes hold.

Denmark saddled with a nagging trade deficit.

While Denmark's recent election yielded small gains for the Social Democrats, the party still lacks a majority and is likely to form a minority government. The new government will face considerable problems, for although GDP growth has been buoyant, the inflation rate has accelerated and the trade balance has deteriorated. Consumer prices in August were 12.3% above the year-earlier figure, compared with 7% in January, and the cumulative trade deficit for the first eight months of 1979 was 13.7 billion crowns, versus 10.1 billion last year. Denmark's persistent trade gap, the country's most pressing problem, has saddled it with a net foreign debt of 65 billion crowns. Interest payments alone now account for some 6 billion crowns, or about one month's export revenues. A devaluation might seem the obvious course, but the Danish system of wage indexation would neutralize most of the benefits by aggravating inflation. Thus, government efforts will focus on the difficult task of winning agreement with the unions on removing import prices from the wage-regulating price index.

Inflationary pressures in Israel continue unabated.

Israeli inflationary pressures show no signs of abating. Over the last three months, prices have risen at an annual clip of 130%. Recent government measures announced to stem the rapid inflationary pace include a freeze on public-sector wages and a cutback on investment in industry to reduce the Government's borrowing needs and slow money supply growth. Private consumption, weakening because of accelerating inflation, the lagged response of wage indexation, and high borrowing costs, should slow further, since the impact of the restrictive measures has been only partially offset by the freezing of some prices. However, even if price rises slow substantially, the average year-on-year inflation rate for 1979 will still approach 75%. And since long-run policy is expected to remain growth-oriented, the long-term outlook is for continued high inflation.

Taiwan's export diversification efforts pay off.

Taiwan is successfully diversifying both its export products and markets. Leading the field in nontraditional exports are industrial machinery and basic metals, with exports of plastics and plywood following close behind. These developments are timely, as Taiwan's traditional exports—textiles and electronics—are feeling the drag of the U.S. slowdown. Exports to the United States were up only 11% in the January-June period, compared with the year-earlier level, implying a decline in real terms. Filling the market gap, however, were Hong Kong, West Germany, Saudi Arabia, and most importantly, Japan. Exports to Japan rose 60% during the first half of 1979, raising the Japanese share of total exports to 15.3% from 12.4% last year. In contrast, the U.S. share dropped from 41.7% to 35.8%. These changes signify substantial progress in redressing the politically-

sensitive imbalances in Taiwanese trade with the United States and Japan. Overall, exports in the first half of 1979 were up 30% to $7.2 billion and imports were up 37% to $6.7 billion, suggesting a trade surplus of about $1 billion for the year. Thus, Taiwan appears to be well positioned to weather the current U.S. recession relatively unscathed.

Australia maintains priority on fighting inflation.

Curbing inflation remains a top priority of the Australian Government. Toward this end, the projected government budget deficit has been reduced to $2.5 billion for fiscal 1980 (July 1979-June 1980) from nearly $4 billion in FY 1979. The lower projection is based on the large increase in the excise duty on crude oil and the anticipation of higher personal income tax receipts, which are the result of a 1.5% tax surcharge in effect for the first half of the year. In addition, the target for money supply growth has been trimmed to 10% in FY 1980 from 12% in fiscal 1979. Upward pressure on consumer prices caused by sharp increases in petroleum costs will continue to work through the economy over the next several months, tempered somewhat by a downtrend in beef prices. Increased wage demands will also contribute to inflationary pressure. But the Government is committed to a more restrictive monetary stance and is willing to accept the consequence of slower growth. As a result, the inflation rate is expected to be held to about 10% in fiscal 1980, compared with 8.4% last fiscal year.

Venezuela's 1980 budget embodies conservative fiscal stance.

The Venezuelan Governments' budget for 1980 underscores the more conservative fiscal policy of the administration of President Herrera. In view of the large spending and debt rises of previous years, the 1980 budget proposes to reduce capital spending and limit current expenditure to only 14%—equivalent to the anticipated annual rate of inflation. Despite the sharp rise in oil prices realized this year, there is a heightened official desire for economic development to proceed more orderly and conservatively. Major capital projects are being scrutinized closely for efficiency and rates of return. The less expansionary budget comes in the context of an economy whose overall growth is progressing more slowly than last year because of fiscal and monetary restraints. As expected, the petroleum sector will see a rapid advance, but other sectors will record more subdued growth in line with policies aimed at bringing about an improved national spending and income balance.

Gabon's external accounts on steady path of improvement.

The improvement in Gabon's external accounts last year is carrying over into 1979. The 25% drop in the value of imports in 1978, traceable mainly to reduced public-sector spending, was largely responsible for widening the trade surplus by 40% to an estimated $790 million and boosting the current-account surplus from $42 million to $200 million. However, net capital outflows, attributable primarily to foreign debt repayment, left a mere $10-million surplus in the overall balance. This year, the recent increase in oil prices could boost export receipts an estimated 30%. Coupled with an import expansion of some 25%, this suggests a trade surplus of over $1 billion, with a corresponding widening in the current-account surplus to over $300 million. And although further substantial debt repayments are anticipated this year, the overall balance appears headed for a wider surplus, as reflected in a rising level of international reserves.

Free-market aluminum prices expected to weaken.

Despite economic weakness in the United States, world demand for aluminum has remained firm this year. Supply, however, has been curtailed by a three-month Alcan strike in Canada and reduced Japanese output. Production has been returning to normal since the early-September strike settlement, and the market has eased in recent weeks. As of August, free-market aluminum prices averaged about 76¢ per pound—27% above year-ago levels—while U.S. producer prices were held to the 60¢-63¢ range by the U.S. Government's voluntary price guidelines and "jawboning" of the big three producers. The start of a new U.S. guideline pricing period on October 1 has permitted further price increases; producer prices have risen to 66¢ per pound since then. Over the next year, free-market prices are expected to decline, with producer prices stabilizing at around current levels as a U.S. recession overlaps with a European and Japanese slowdown.

A Rebound, Not a Recovery

Statistical surprises announced over the past two weeks, including a larger-than-expected surge in GNP growth, have compounded the confusion over where we now stand in the current business cycle. Preliminary government estimates placed third-quarter real growth at 2.4%, a fairly hardy turnaround from the second quarter's 2.3% decline. Strong increases in retail sales and the stability of industrial production since the previous quarter lent support to the growth figures. But after discounting the statistics for the erratic behavior of the automotive industry, the recent display of strength is probably more indicative of an end-of-summer fling than of the future direction of the economy—particularly in light of the recent credit-tightening actions announced by the Federal Reserve Board.

Retail sales, for example, rose 2.2% in September on top of a heftily revised 3.1% increase in August. Special rebate and discount programs designed by domestic automakers to help move bulging inventories of 1979 models helped to boost sales. And the increased availability of gasoline induced consumers to make auto purchases postponed because of earlier gas lines. However, when adjusting these two large monthly gains for inflation, real sales are only slightly ahead of year-ago levels. Moreover, real disposable personal income is lower than it was at end-1978, despite a reduction in income taxes at the beginning of 1979. And consumer credit expansion slowed markedly in July and August. Thus, the ingredients needed to sustain the recent strength are absent.

Business inventory policy is another sign of the hollowness of the rebound. The book value of manufacturing and trade inventories in August grew 0.8%, the smallest monthly rise this year. The relatively moderate rise followed July's huge 1.9% growth in inventory accumulation. The moderation was welcome, since excessive inventory levels eventually trigger cutbacks in production and higher unemployment. In fact, industrial production declined 0.9% in August. But it rebounded 0.5% in September, mostly the result of a 5% jump in auto output. Few industry observers expect Detroit's upturn to be sustained, however, and auto production is scheduled to taper off in the fourth quarter.

Declining sales and the fear of excessive inventory accumulation will lead to a cautious inventory policy in the coming months. And the recent Fed actions will reinforce the incentives for such an approach, since inventories become increasingly expensive to carry as interest rates are pushed higher. Coupled with the anticipated slowdown in consumer spending, the reduced inventory investment should unambiguously herald a true recession in early 1980.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALANCE OF				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered	use o credit lions of
Argentina	Decreasing rate of monthly peso devaluations being maintained through March 1981.	Mar.	+ 15%	55.0	$2,076	June	7,717	+ 55%	23.6	(
Barbados	New five-year industrial development plan aims at attracting manufactured export industries.	Jan.	— 13%	0.5	1,984	Aug.	79	+ 53%	2.8	
Brazil	Government encouraging purchase and production of alcohol-powered vehicles to cut oil imports.	Apr.	+ 14%	190.9	1,654	June	10,110	+ 25%	7.7	(
Chile	Austerity in public sector introduced in effort to moderate inflationary pressure.	June	+ 53%	15.6	1,440	July	1,583	+ 63%	5.6	19
Colombia	Foreign investment rising sharply as companies already present reinvest "limbo funds."	May	+ 19%	23.1	895	Aug.	3,472	+ 67%	15.3	
Costa Rica	Revised official statistics put real GDP growth at 5.9% in 1978, down from 7.7% in 1977.	June	— 21%	3.5	1,650	Aug.	77	— 68%	0.7	3
Dominican Rep.	Productive activity sharply curtailed as consequence of severe hurricane damage.	June	+ 4%	4.4	860	Aug.	152	+ 45%	1.8	5
Ecuador	Large new budget allocations based on increased taxes and improved collection.	Apr.	+ 19%	7.2	924	Aug.	708	+ 7%	5.1	
El Salvador	President Romero ousted; new leaders seek moderate and nonviolent national solutions.	June	+ 5%	6.3	942	Aug.	293	+ 83%	3.4	
Honduras	Economic slowdown expected this year as tighter liquidity hinders investment expansion.	Apr.	+ 20%	1.7	570	June	190	— 19%	3.2	
Mexico	Inflation rate rises to 20% annual pace as money supply expands strongly.	June	+ 50%	92.8	1,386	May	2,011	+ 15%	2.5	1
Nicaragua	War damage to productive sectors estimated at $480 million; agriculture has reconstruction priority.	Mar.	+ 19%	2.4	995	Dec.	51	— 66%	0.8	
Panama	Panama assumed control over much of Canal Zone on October 1, as new treaty became operational.	Mar.	— 29%	3.4	1,868	May	113	+ 8%	1.4	
Peru	Real GDP estimated to have grown 3% in first half of 1979 after several years of decline.	June	+187%	10.7	640	July	651	+ 80%	5.1	4
Puerto Rico	U.S. recession and hurricane damage have adverse impact in form of lower output and higher prices.	July	+ 17%	8.8	2,650	Aug.	7,713*	+ 16%	12.8	
Trinidad & Tobago	Crude oil exploration efforts stepped up to augment declining production of old wells.	May	+ 5%	3.6	3,215	Aug.	1,797	+ 10%	12.0	
Uruguay	Both economic expansion and inflation rate exceeding targeted levels.	Mar.	+ 25%	5.0	1,590	May	825	+ 67%	14.0	
Venezuela	New 1980 fiscal budget aims at limiting spending growth so as to restore balance to economy.	May	+ 21%	41.2	3,150	July	5,865	— 18%	8.8	

*Commercial bank deposits

Bond Market Plagued By Uncertainty

Bond market participants are still in shock from the market's adverse reaction to the Federal Reserve's October 6 policy move and the spate of unfavorable news in its wake. Since the Fed's announcement, the prices of long-term (greater than 20-year-maturity) Treasury bonds have plummeted about 8% on average—a decline unprecedented in recent times for such a short period. The drop in the prices of low-rated corporate bonds was even more precipitous.

This sharp decline startled a number of analysts—and probably the Fed as well. The primary purpose of the Fed's actions—especially its announced intention to place greater emphasis on controlling the supply of bank reserves—was to reduce future inflation. And since inflationary expectations are a major determinant of bond yields, a moderation in such expectations should, other things being equal, have a *downward* impact on bond yields, or equivalently, an *upward* impact on bond prices.

A major reason for the strongly adverse effect of the Fed's announcement on bond prices has undoubtedly been rising uncertainty. It is still unclear how the new policy will actually affect the Fed's operating strategy. Nor is it clear how long the new policy of focusing on the supply of bank reserves will continue. Moreover, there is a growing fear that a "credit crunch" may be at hand—i.e., a period of credit-market dislocation during which non-price credit rationing is widespread, and credit availability to certain types of borrowers is curtailed regardless of interest rates paid. Finally, there is increased doubt over the near-term outlook for the U.S. economy. In sum, uncertainty has prompted many investors to stay out of the bond market until the Fed's intentions can be more accurately assessed and the economic outlook becomes clearer.

It is also uncertain how the Fed views the recent chaotic conditions in the bond market. In the past, one of the major objectives of the Fed has been to foster "orderly" market conditions. Thus, some analysts feel that if the wide fluctuations in bond prices continue, the Fed will consider steps to stabilize the market.

One may take the view, however, that a sense of instability in financial markets will contribute to the anti-inflation program undertaken by the Fed. For example, some economists believe the only effective way to slow inflationary momentum is to trigger a credit crunch and thus curb spending. From this perspective, since the so-called "gradualist" policy of the Fed during most of 1979 failed to contain inflation or money and credit growth, a financial shock was needed to slow money growth and thus check inflation. Recent statements by Fed officials, however, suggest a concern about the recent conditions in financial markets, and efforts have been made to allay crisis sentiment.

AYMENTS		MONEY AND BANKING						COUNTRIES
MF nil-ollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars, October 24, 1979	current monetary conditions
	Overvalued currency spurs higher spending on tourism and imports.	May	+ 153%	May	+ 170%	18.00%	.00071	Cut in banks' minimum reserve ratio.	Argentina
	Income from tourism rose 22% in 1978.	July	+ 13%	June	+ 7%	—	.5200	Bank deposits up sharply in January-March 1979.	Barbados
	Cruzeiro mini-devaluation pace accelerated.	May	+ 46%	May	+ 49%	33.00%	.0340	Monetary authorities want interest rates reduced.	Brazil
	Steady reduction in tariffs—10% with some exceptions—spurs import rise.	Aug.	+ 35%	Dec.	+ 58%		.0270	Central Bank encouraging greater banking competition.	Chile
	Coffee exports totaled a record $2.1 billion in fiscal 1979.	May	+ 23%	May	+ 17%	20.00%	.0270	Tight liquidity conditions prevail.	Colombia
	End-August official reserves down 60% to $77 million from end-1978.	June	+ 8%	May	+ 43%		.1200	Increased liquidity.	Costa Rica
	Grim outlook for external sector owing to reduced FX-earning capacity.	Apr.	+ 5%	Mar.	+ 14%	—	Par	Demand for credit up sharply.	Dominican Rep.
	Manufactured exports show strong rise.	June	+ 12%	May	+ 36%	8.00%	.0400	Large increase in bank loans.	Ecuador
	Controls imposed to stem foreign-exchange outflows.	June	+ 7%	July	+ 2%	—	.4030	Increased capital flight.	El Salvador
	Official reserves as of June down 19% from year-earlier level.	July	+ 9%	Apr.	+ 17%		.5015	Monetary policy restrictive.	Honduras
	Mexican oil price raised to $24.60 per barrel.	June	+ 18%	May	+ 30%	4.50%	.0445	Bank deposit rates increased.	Mexico
	State-run company created to control principal exports and imports.	Sept '78	+ 4%	Apr.	+ 45%	—	—	High-denomination bank notes removed from circulation.	Nicaragua
	International banking sector grows rapidly.	Apr.	+ 7%	June	+ 8%	—	Par	Strong deposit and credit creation since end-1978.	Panama
	All financial restrictions on imports lifted.	Apr.	+ 80%	Apr.	+ 53%	—	.0043	Stiff marginal reserve requirements imposed.	Peru
	Tourism down in August-September period.	Aug.	+ 6%	Aug.	+ 9%	29.50%	1.00	Loan growth declines from previous high rate.	Puerto Rico
	Trade surpluses widened in April-May period.	June	+ 12%	Apr.	+ 26%		.4300	Bank liquidity ample.	Trinidad & Tobago
	Tariff barriers reduced on wide range of clothing and foodstuffs.	June	+ 63%	Dec.	+ 71%	—	.1250	Interest rate ceilings lifted.	Uruguay
	Higher oil prices to produce 1979 trade surplus.	June	+ 10%	May	+ 33%	8.50%	.2335	Bank liquidity declined in August.	Venezuela

World Interest Rates

market rates of October 24, 1979; bond yields as of October 19, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00*	14.00	10.00	9.50	5.00	12.00 penalty rate 15.00	8.00	1.00	5.25
Day-to-Day Money	14.50 Oct. 25	13.25	14.25	10.95	11.50	8.10	12.50	8.75	1.75	6.9375
Treasury Bills 91-day, Middle Rates	12.70	12.70	13.3125	13.75 120-day	n. a.	n. a.	11.85 99-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	12.875 finance paper	14.00 finance paper 15% tax w/h	12.95 H. P. on discount basis	9.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.35	14.00 15% tax w/h	13.875	12.00 Certified	not traded	7.40	n. a.	no market	3.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.08	11.50	12.67	9.24 20% tax w/h	10.44	7.80	13.39	8.84	3.50	7.89
Industrial Bonds prime, long-term, new and old issues, average yield	10.75 Aa Industrials	12.00	13.05	12.25 20% tax w/h	11.84	7.90	13.78	9.36	4.70	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.00	14.75*	15.00	14.00	10.10	7.25	17.00	11.50	4.00	5.50
Bank Time Deposits 3-month	14.00 Cert. of Dep	13.75 Cert. of Dep	14.375 Cert. of Dep	14.20	12.625	8.85	10.00	10.00 large deposits	3.4375 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	15.50	no market	14.25	no market	13.625	8.5625	no market	9 6/2	3.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8455	2.1150	.034575	.2369	.5547	.001201	.4996	.6044	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.125 *P*	.50 *P*	1.625 *P*	1.75 *P*	6.75 *P*	1.375 *D*	6.00 *P*	12.50 *P*	7.375 *P*

Eurodollar Deposits
(London, interbank, bid)
October 25

7-day	16.25
1-month	15.25
3-month	15.5625
6-month	15.3125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .93
U.S.-Canada Treasury Bills	− .57
U.S.-Canada Finance Co. Paper	−2.06
Eurodollars-U.K. Local Auth. Deposits	+1.00

Eurobonds**
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.25
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	7.625
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
395.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Rates as of Oct. 25. **Eurobond rates as of Oct. 17.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.8 (Aug.)	9.6 (Sept.)	16.5 (Sept.)	10.8 (Aug.)	4.9 (Aug.)	15.5 (Aug.)	4.8 (Sept.)	3.1 (Aug.)
Industrial production*	2.5 (Sept.)	−0.1 (Aug.)	−4.0 (Sept.)	5.5 (Aug.)	5.1 (Aug.)	3.7 (July)	−3.0 (June)	8.9 (Aug.)
Trade balance† *(billions of local currency units)*	−$2.4 (Aug.)	−C$.141 (Aug.)	−£.100 (Sept.)	−FF1.79 (Sept.)	DM.98 (Aug.)	Lt583 (Aug.)	−SF.445 (Sept.)	−¥163 (Sept.)
Money supply (M_1)*	4.7 (Sept.)	6.2 (Sept.)	12.4 (July)	12.3 (July)	11.1 (Aug.)	22.8 (May)	13.8 (July)	11.1 (Aug.)
Velocity of money (M_1)*	6.6 (June)	5.4 (June)	−4.0 (Dec.)	n. a.	−3.1 (Mar.)	−5.6 (Dec.)	n. a.	−4.0 (Mar.)
Reserves *(millions of U.S. $, end of period)*	20,907 (Aug.)	4,276 (Aug.)	20,901 (Aug.)	19,608 (July)	51,785 (Aug.)	22,674 (Aug.)	17,138 (Aug.)	25,475 (Aug.)

* Percent change from 12 months earlier.
† Figures are only for the month indicated

Italian Economy Makes Structural Progress

Beginning with the formation of the EEC in 1958 until the oil crisis of 1973, Italy's economy registered one of the highest growth rates in Europe—4.9%. Foreign trade expanded more than twice as fast as GDP, gross investment averaged about 21% of output, and the current account remained roughly in balance.

In the early 1970s, however, several structural problems emerged. First, Italy's total lack of domestic raw materials left it vulnerable to world commodity price increases. This was particularly apparent in the wake of the 1973/74 oil price hike when Italy was importing 82% of its primary energy. Second, wage indexation prevented a downward adjustment in real wages in response to the oil price shock, so that the entire burden of adjustment fell on profits and employment, leading to a decline in investment relative to GDP. Third, Italy's public-sector borrowing requirement (PSBR) accelerated, both for demographic reasons and because the Government was forced to subsidize investment, employment, and unemployment. The large and growing PSBR forced policymakers to choose between inflationary financing of the PSBR (i.e., printing money) and crowding out the private sector. Finally, Italy's money and capital markets were relatively undeveloped, making it difficult to finance its current-account deficits.

The combination of these structural problems resulted in a marked cyclicality of policy and economic performance in the 1970s. Economic upswings led to rapid monetary growth, rising inflation, and a large balance-of-payments deficit. This was countered by tight monetary policy, a crowding out of private investment, an economic downswing, and an external payments surplus.

Italy's structural deficiencies have been remedied to some extent. Dependence on imported energy was cut from 82% in 1974 to 78% last year, and Italy's energy-consumption-to-GDP ratio was reduced from 1.07 in 1974 to 1.04 in 1978.

More importantly, Italy has sharply increased its share of world exports since 1974, largely because of its improved international price competitiveness and reduced profit margins in domestic markets. Export volume grew 38% during the 1974-1978 period, compared with growth in world trade volume of only 16%.

Another structural change evident since 1974 has been a broadening and deepening of Italy's money and capital markets, facilitated by large issues of government debt to finance the PSBR. The more mature financial markets ease the financing of any future Italian current-account deficits because they provide greater scope for autonomous financial investment in Italy.

Two major structural problems persist, however: the growing PSBR and wage indexation. Public spending, particularly on transfer payments, continues to grow rapidly, expanding the PSBR even relative to GDP, despite improvements in tax collections. As wage indexation is expected to remain in force for another three years, the latest oil price rises will have to be financed out of profits and employment, barring an unforeseen acceleration in productivity. This suggests a further decline in real investment relative to GDP.

Italian monetary and fiscal policies were highly expansionary last year. The PSBR amounted to some 14.5% of GDP, and the broad money stock grew roughly 23%, or over 10% in real terms. As a result, economic activity was particularly intense in the fourth quarter of 1978 and continued brisk through the first quarter of 1979. While labor unrest has distorted the more recent statistics, underlying economic growth appears to be slowing.

Italy's inflation rate in 1978 stabilized at the 12% level, as domestic inflation was masked by the weakness of the U.S. dollar, which held lira import price rises to only 4.5%. As the dollar stabilized in late 1978, however, the inflation rate accelerated to a 17% annual rate in the first eight months of 1979. An even more rapid rate may be expected for the remainder of the year. The 1979 PSBR is expected to reach some 38 trillion lira, and nominal money supply growth continues to exceed 20%. Furthermore, the recently-completed, three-year national wage negotiations left the wage indexation system virtually intact. It is estimated that real wages will increase some 3% on an average annual basis over this period.

On the external front, Italy posted a record $6.2-billion current-account surplus in 1978, the second largest in Europe. In volume terms, export growth exceeded import growth (11.4% versus 8.7%) and terms of trade improved by some 2.5%, thanks to the dollar's weakness. For this year, the combination of rapid Italian growth, accelerated stockbuilding, and the impact of sharply higher oil prices is likely to halve Italy's current-account surplus to the $2.5-$3.0-billion range. A sharp slowdown in world trade expected for 1980 should lead to a balanced current account. However, another rise in oil prices or more expansionary Italian economic policy could tilt the current-account balance into deficit. (The 1980 budget proposals recently submitted to Parliament incorporate a PSBR of some 40 trillion lira. However, Parliament may still substantially modify the package.)

Italy's underlying rate of growth is expected to slow in the second half of 1979, mainly because of weakening real investment. The official forecast is for real GDP growth of over 4% for the year as a whole, with economic growth expected to slow to some 2.5% in 1980. Even this figure may prove overly optimistic, given the expected deceleration in world trade volume and the more restrictive monetary policy that will be necessary to contain inflation and protect the lira.

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Tracing Eurocurrency Market Growth

The Eurocurrency market has grown rapidly in almost every year since its inception. Last year was no exception, with the gross size of the market increasing by some 30%. In the first half of 1979, however, growth slowed to an estimated 10% annual rate, partly the result of the dollar's stability during this period. (Since the Euromarket is measured in dollars, a substantial dollar depreciation, such as occurred in 1977 and 1978, triggers a rapid appreciation in the dollar-value of the non-dollar component of the Eurocurrency market.) The slower growth in first-half 1979 also reflects the implementation of tighter monetary conditions worldwide.

In projecting Eurocurrency market activity in 1980, a variety of factors must be considered. Of particular importance are: the trends in world monetary conditions and inflationary prospects; the general performance of the dollar in foreign-exchange markets; the growth of world trade; the new marginal reserve requirements in the United States; and the world impact of the OPEC price hikes.

The current trend in world monetary conditions is toward higher short-term interest rates as a means of curbing future inflation. Such policies are now being pursued in both the United States and Germany, and they will tend to depress overall Eurocurrency market growth. Also, U.S. authorities have indicated an increased willingness to defend the dollar against a major depreciation. This makes unlikely the extremely rapid expansion of Eurocurrency market size that another round of general dollar depreciation would engender. Another factor favoring slower Eurocurrency market growth is the projected slowdown in the growth of world trade in 1980.

Offsetting these factors, the sharp hikes in the world oil price and the resulting OPEC surpluses will have a major impact on Eurocurrency market growth. First, the Eurocurrency market will capture a large share of OPEC short-term funds. And second, countries in deficit positions will be forced to turn to the international capital markets for balance-of-payments funding. Also supportive of rapid growth are the new monetary regulations introduced in the United States that require domestic U.S. banking offices to hold 8% marginal reserves against managed liabilities. This provides an increased incentive for U.S. banks to book foreign loans in offshore markets.

On balance, the growth of the Eurocurrency market is likely to pick up rapidly in the second half of 1979 —to an annual pace comparable with that of 1978— and then drop to approximately a 20% rate in 1980. Accordingly, the gross size of the market could exceed $1 trillion dollars by late 1979, and could reach $1.3 trillion by end-1980.

It is well known that the gross size of the market is an overstated indicator of loan growth because of significant double-counting of bank positions; however, even the net size measures contain sizable bank and official transaction components. Thus, actual lending to private nonbanks is perhaps the more revealing measure. Such loan activity is expected to grow much more slowly, by about 10% in 1980, following 15% growth estimated for 1979. Lending to public authorities, which grew less than 15% in the first half of 1979, should accelerate in 1980, very possibly to 40%.

As a final note, the share of Eurocurrency lending captured by U.S. banks may rise in 1980 for several reasons. First, the negative impact of a depreciating dollar will be absent, or at least much less significant than in past years. Second, certain competitors, particularly the Japanese banks, may be less active. And third, the impact of the new U.S. marginal reserve requirements will provide profit incentives for U.S. banks to turn to the international markets.

Bluford H. Putnam

Eurocurrency Market

($ billions, end of period)

	IIIQ/78	IVQ/78	IQ/79	IIQ/79	1978	1979 (est.)	1980 (est.)
Total Market Size							
Gross Size (Claims)	793.5	892.1	882.6	935.0	892.1	1,075.0	1,300.0
Net Size (Claims)	495.0	535.0	545.0	575.0	535.0	650.0	780.0
Liabilities to Private Nonbanks	125.0	140.0	145.0	155.0	140.0	170.0	205.0
Claims on Private Nonbanks	260.0	280.0	285.0	295.0	280.0	320.0	360.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	245.8	259.9	272.9	295.8	259.9	315.0	380.0
Liabilities to Private Nonbank Foreigners	51.8	57.8	57.6	60.5	57.8	72.0	87.0
Total Claims on Foreigners	293.2	322.8	315.1	328.4	322.8	355.0	430.0
Claims on Foreign Public Borrowers	31.9	33.8	35.7	36.0	33.8	40.0	55.0
Claims on Foreign Private Nonbank Borrowers	99.7	104.3	103.5	107.7	104.3	120.0	135.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the Eurocurrency interbank component. Net size includes transactions between banks in the Euromarkets and: (a) official monetary authorities; (b) banks not participating in the Eurocurrency market; and (c) nonbanks.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.